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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 189

BENJAMIN B. FOSTER AND ROBERT R. TODD, EXECUTORS OF THE ESTATE OF ANNA FOSTER FORD, DECEASED, PETITIONERS

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The original opinion of the court below (R. 7–15) is reported in 17 F. Supp. 191. Its supplemental opinion on petitioners' motion for a new trial (R. 15–19) is reported in 18 F. Supp. 790.

JURISDICTION

The original judgment of the court below was entered December 7, 1936. (R. 15.) The order overruling petitioners' motion for a new trial was entered April 5, 1937. (R. 19.) The petition for a writ of certiorari was filed July 2, 1937 (R. 19), and granted on October 11, 1937 (R. 20). The

jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether a dividend in 1930 was paid from earnings or profits accumulated after February 28, 1913. This depends upon whether the amount expended by the corporation in 1929 to redeem a portion of its stock is to be allocated against such earnings and thus exhaust them.

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory provisions and Treasury Regulations are set forth in the Appendix, *infra*, pp. 22–24.

STATEMENT

This suit was brought to recover an alleged overpayment of income taxes for the year 1930. (R. 1–6.) The plaintiff died during this litigation and the executors of her estate, the petitioners herein, were substituted as parties. (R. 7.)

On February 11, 1930, decedent was the owner of 155 shares, par value $100 each, of the total of 1,500 shares of the capital stock of the Foster Lumber Company, a Missouri corporation. (R. 8.) On that day the corporation declared and paid a 150% cash dividend, namely, $225,000, on its capital stock, and decedent received as her share thereof the amount of $23,250, which she included in her income tax return for that year. (R. 8.)

Thereafter, decedent duly filed a claim for refund for the year 1930, contending that of the cash

dividend received by her only a portion thereof was paid from earnings or profits accumulated after February 28, 1913, and the dividend was therefore exempt to the extent of the remaining portion. The Commissioner of Internal Revenue rejected the claim upon the ground that there were ample earnings or profits (more than $225,000) accumulated since February 28, 1913, from which the dividend could have been paid. (R. 8.) The relevant facts in this regard are as follows:

On March 1, 1913, the corporation had outstanding 2,000 shares of its common stock having a par value of $100 each. Its accumulated earnings and increase in value of property at that date were in excess of $3,725,000.[1] (R. 8.) On October 10, 1929, in order to permit some of the stockholders to retire from ownership of and participation in the affairs of the corporation, it purchased and canceled 500 of the outstanding 2,000 shares of its cap-

[1] Between March 1, 1913, and October 10, 1929, the critical date herein, that amount had been only slightly reduced by dividends. In 1914, a dividend of $100,000 was paid, there being on hand at that time only $57,811.02 earnings accumulated *since* February 28, 1913; and in 1915 a similar dividend of $100,000 had only $48,798.73 recent earnings behind it. (R. 9–10.) All other dividends paid to 1929 were from earnings and profits accumulated subsequent to February 28, 1913. Accordingly, at the critical date, October 10, 1929, the only dividends which were paid from the March 1, 1913, surplus of over $3,725,000 were the 1914 dividend to the extent of $42,188.98 and the 1915 dividend to the extent of $51,201.27. Thus, on October 10, 1929, the March 1, 1913, surplus of over $3,725,000 had been reduced by total dividends of less than $100,000.

ital stock, expending therefor $1,025,000 cash. (R. 10.) This purchase of stock was on the basis of $2,050 per share, and it was subsequently agreed between the stockholders and the Government that the value of the stock on March 1, 1913, was also $2,050 per share. (R. 10–11.)

Immediately prior to the retirement of the 500 shares on October 10, 1929, the corporation had on hand earnings and profits in the amount of $330,578.98, accumulated since February 28, 1913. Additional earnings and profits in the amount of $82,758.17 were accumulated from October 10, 1929, to February 11, 1930, the date of the $225,000 dividend here involved. (R. 11.)

The taxpayer contended that the expenditure of $1,025,000 on October 10, 1929, exhausted all of the earnings and profits accumulated since February 28, 1913 ($330,578.98), and that therefore the $225,000 dividend paid on February 11, 1930, was taxable only to the extent that there were earnings or profits subsequent to October 10, 1929 (i. e., to the extent of $82,758.17). The Court of Claims, however, held that the October 10, 1929, expenditure was a capital transaction and was not to be charged against the earnings and profits accumulated since February 28, 1913.[2]

[2] The Board of Tax Appeals has held to the contrary in an unreported decision involving another stockholder in the same corporation. *Craig* v. *Commissioner*, decided March 15, 1937, now pending upon appeal to the Circuit Court of Appeals for the Eighth Circuit.

SUMMARY OF ARGUMENT

1. The redemption by the Foster Lumber Company of 25% of its stock in 1929 was a capital transaction. It was not the ordinary type of corporate distribution, and accordingly does not come within the purview of Section 115 (b).

2. Section 115 (b) creates an artificial presumption that corporate distributions are to be treated as having been made from earnings accumulated since February 28, 1913, to the extent thereof. This provision was intended to tax as dividends all corporate distributions to the extent that there were such earnings from which the distributions could have been made. It shows the general purpose of Congress to reach all such earnings, and to reach them in the hands of the stockholders as soon as possible. Accordingly, to apply Section 115 (b) to a non-taxable *capital* exchange would artifically deplete or wipe out the earnings account for future taxable distributions, and would thus frustrate the very object that Congress was trying to accomplish. Accordingly, we submit that Congress could not have intended Section 115 (b) to apply under such circumstances.

The lower courts have arrived at the same result in the analogous cases involving a consolidation of several corporations, each with a separate earnings account. Although in such cases those earnings accounts had been capitalized by the new corporation, and although stock of the new corporation had been *distributed* to the old stockholders so that

they might have been taxed upon such receipts in the absence of a specific statutory exemption, it has nevertheless been held that the old earnings accounts remain intact for the purpose of future taxable dividends. There is no more occasion for applying Section 115 (b) here than in those cases.

3. Assuming that Section 115 (b) does not apply, it then becomes pertinent to inquire how the $1,025,000 expended by the corporation in 1929 is to be allocated against the various corporate accounts. The Court of Claims held that since this taxpayer realized no taxable gain upon the redemption, and since the redemption was purely a capital transaction, none of it may be charged against the earnings accumulated after February 28, 1913. We think that result is sound. However, we suggest a second method which is perhaps an even more realistic approach to this question. This second method regards each share of stock as having behind it a proportionate share of each account. Accordingly, under this system, the payment of $1,025,000 in 1929 would be spread evenly over paid-in capital, earnings accumulated before March 1, 1913, and the more recent earnings. The result would be that there would be ample earnings left from which the corporation could have declared on February 11, 1930, its cash dividend of $225,000.

4. But even if Section 115 (b) is applicable, however, the 1929 redemption did not exhaust the recent earnings account. Section 115 (c) provides an exemption from the presumption established by

Section 115 (b) for the part "properly chargeable to capital account," and as there used "capital account" includes not only paid-in capital but also the March 1, 1913, surplus.

ARGUMENT

THE 1929 REDEMPTION WAS A CAPITAL TRANSACTION AND THE PRESUMPTION IN SECTION 115 (B) AS TO SOURCE OF DISTRIBUTION IS THEREFORE NOT APPLICABLE

1. *Preliminary.* The court below held that the redemption and retirement of the 500 shares on October 10, 1929, was a distribution in partial liquidation and capital transaction. This result seems plainly to follow from Section 115 (h) of the Revenue Act of 1928 (c. 852, 45 Stat. 791), which defines a "partial liquidation" as including "a distribution by a corporation in complete cancellation or redemption of a part of its stock," and from Section 115 (c), which provides as follows:

> *Distribution in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. * * * In the case of amounts distributed in partial liquidation * * * the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the

> meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

Petitioners contend, however, that of the $1,025,000 employed to redeem the 500 shares, $50,000 is chargeable to capital account, and that the remaining $975,000 must first be marshalled against the earnings or profits accumulated since February 28, 1913 (i. e., $330,578.98), before any of it can be applied against the earnings or profits on hand accumulated prior thereto. And to reach that result they must, of necessity, rely upon Section 115 (b), which provides:

> *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

It is the Government's position that Section 115 (b) was enacted in order to tax as dividends any distributions made to stockholders to the extent there are earnings or profits accumulated after February 28, 1913, and that it was not intended

artificially to deplete such earnings account by a non-taxable capital exchange upon partial liquidation.

2. *The purpose of Section 115 (b) shows that it was not intended to apply to liquidations.*—In its present form Section 115 (b) of the Revenue Act of 1928 first appeared as Section 201 (b) of the Revenue Act of 1924 (c. 234, 43 Stat. 253). Those provisions and their precursors in earlier Revenue Acts[3] were intended by Congress to create an artificial presumption, so that corporate earnings could be taxed as soon as possible to the stockholders. No doubt, Congress had anticipated that in the absence of such provisions, various devices would be resorted to, such as purported distributions of capital, etc., in order to avoid the incidence of the tax upon the stockholders. To thwart such avoidance and to tax the stockholders at the earliest possible time with respect to the corporation's earnings, it was provided in substance by Section 115 (b) and its predecessors that any distribution which could be allocated against earnings from which taxable dividends could be declared would conclusively be presumed to have been made from such account.

[3] Somewhat similar provisions had appeared, as Section 201 (b) of the Revenue Act of 1921 (c. 136, 42 Stat. 227), and Section 201 (b) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057). Section 1211 of the Revenue Act of 1917 (c. 63, 40 Stat. 300) added Section 31 (b) to the Revenue Act of 1916 (c. 463, 39 Stat. 756), providing not merely that distributions were to be charged against the most recent earnings but that the rate of tax was to depend upon the rate in effect at the time such earnings had been received by the corporation. See *Edwards* v. *Douglas*, 269 U. S. 204.

And in recognition of this purpose, the courts have generally applied those provisions to tax a stockholder-distributee whenever there were in fact any corporate earnings that could have supported the distribution. See *Baker* v. *Commissioner*, 80 F. (2d) 813, 815 (C. C. A. 2d); *Faris* v. *Helvering*, 71 F. (2d) 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Leland* v. *Commissioner*, 50 F. (2d) 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656; *Hadley* v. *Commissioner*, 36 F. (2d) 543, 544 (App. D. C.). Cf. *Edwards* v. *Douglas*, 269 U. S. 204. Indeed, so zealous have the courts been in giving effect to the purpose of Congress to reach such earnings that where several corporations have combined under a new corporate structure capitalizing the accumulated earnings, it has been held, notwithstanding the absence of a specific statutory provision to that effect, that for tax purposes the earnings accounts remain intact. *Commissioner* v. *Sansome*, 60 F. (2d) 931 (C. C. A. 2d); *United States* v. *Kauffmann*, 62 F. (2d) 1045 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. (2d) 641 (C. C. A. 5th); *Baker* v. *Commissioner*, 80 F. (2d) 813 (C. C. A. 2d). Similarly, where a corporation capitalizes its earnings and distributes non-taxable stock dividends, it has been consistently held that the earnings account has not been impaired for dividend purposes.[4] And while the

[4] *Walker* v. *Hopkins*, 12 F. (2d) 262 (C. C. A. 5th), certiorari denied, 271 U. S. 687; *Horrmann* v. *Commissioner*, 34 B. T. A. 1178, 1182; *McCord* v. *Commissioner*, 31 B. T. A. 342; *McCulloch* v. *Commissioner*, 29 B. T. A. 67, 71–73; *Untermyer* v. *Commissioner*, 24 B. T. A. 906; *Hedrick* v.

stock dividend cases may possibly be explained away upon the ground that the issuance of a stock dividend is not a "distribution" (cf. *Eisner* v. *Macomber*, 252 U. S. 189), the reorganization cases remain as cogent authority here since exchanges in reorganization, like distributions in partial liquidation, are relieved of tax only by virtue of a specific statutory exemption. Cf. *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536.

Accordingly, two things stand out clearly with respect to the general purpose of Congress. First, any distribution that can be taxed as a dividend by being charged against available corporate earnings is conclusively deemed to have been made from such earnings. And second, in furtherance of the first objective, if there is a non-taxable capital distribution, the earnings account is to remain intact for the purpose of future taxable distributions.

That Congress intended to treat partial liquidations distinct from ordinary corporate distributions plainly appears from Section 115 (c). There Congress provided that amounts so received by the stockholder, instead of being taxed as ordinary dividends, should "be treated as in part [5] or full

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Commissioner, 24 B. T. A. 444, 453–457; *Megeath* v. *Commissioner*, 5 B. T. A. 1274, 1285; *Kennish* v. *Commissioner*, 4 B. T. A. 303; *Wilson* v. *Commissioner*, 3 B. T. A. 957.

[5] There are two kinds of partial liquidation as defined in Section 115 (h). The first type is the "complete cancellation or redemption of a part" of the stock, as was the case here. The second type is "one of a *series* of distributions in

payment in exchange for the stock." And it is further provided that "the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation."

Section 115 (c) of the 1928 Act first appeared in the law as Section 201 (c) of the Revenue Act of 1924, and the reports of both the Senate and House Committees with respect to the bill which became the 1924 Act, plainly indicated that Congress understood these provisions as dealing with capital transactions as distinguished from ordinary distributions. The Senate Finance Committee stated (S. Rep. No. 398, 68th Cong., 1st Sess., pp. 11–12):

> * * * A liquidating dividend is, in effect, a sale by the stockholder of his stock to the corporation; he surrenders his interest in the corporation and receives money in place thereof. * * *
>
> The theory of liquidating dividends is extended to distributions in partial liquidation. If a corporation retires a portion of

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complete cancellation or redemption of all or a portion" of the stock. [Italics supplied.] Accordingly, the part payment referred to in Section 115 (c) presumably refers to this second type of distribution in partial liquidation. The type of partial liquidation involved herein, however, should therefore be treated as in "*full* payment in exchange for the stock" within the meaning of Section 115 (c). [Italics supplied.]

> its capital stock, the transaction is treated, from the point of view of the stockholder, as a sale of his stock. If the corporation distributes an amount in partial retirement of its capital stock, the amount thereof is to be considered as a return of capital, and taxable only if, as, and to the extent that it exceeds the basis of the stock.

Similar comments appear in the report of the House Ways and Means Committee report. See H. Rep. No. 179, 68th Cong., 1st Sess., pp. 11–12.

The purchase by the Foster Lumber Company of 25% of its own stock for redemption was therefore not a "distribution" in the dividend sense. It was a capital transaction, and the stockholder might either realize gain or suffer loss depending upon whether the amount received exceeded or was less than the basis for such stock. And as to the stockholder in this very case no taxable gain was realized, since the stock which was redeemed at the rate of $2,050 a share had the same value on March 1, 1913, the critical date for determining the basis of this stock. (R. 10–11.)

Thus, to apply Section 115 (b) here would frustrate the very end that Congress was attempting to achieve by those provisions. The artificiality of the presumption, together with the cases applying it, plainly show that Congress was deeply concerned not only with taxing corporate earnings to the stockholder but with imposing the tax as soon as possible. If the Section 115 (b) formula were

employed here, the earnings account would be exhausted in a nontaxable exchange, and the corporation would be free to distribute the earnings actually remaining, exempt from tax to the stockholder. That Congress could have intended so perverse a result to follow from the very language that it had carefully employed to subject the stockholder to tax seems difficult if not impossible to believe.

We respectfully submit that Section 115 (b) is applicable to distributions as that term is commonly understood where the distribution might be treated as a dividend, and that it is not to be applied where there are capital transactions in the nature of stock redemptions. Cf. *Lynch* v. *Hornby*, 247 U. S. 339, 341. That capital transactions are to be treated differently from ordinary distributions, has already been recognized by the lower courts in holding that upon consolidation or merger of two or more corporations, the earnings accounts of the combining corporations remain intact in spite of the technical distribution to the stockholders that generally occurs under such circumstances. There is no more occasion for applying Section 115 (b) here than in those cases.*

* The petition for certiorari herein suggests that the presumption was applied in *Harter* v. *Helvering*, 79 F. (2d) 12 (C. C. A. 2d), and that since that case involved a distribution in partial liquidation, the decision is contrary to that of the Court of Claims here. The two cases, however, are consistent. First, while there was a distribution in redemption of stock by the Boxboard Products Company in that case,

3. *The proper allocation of the redemption in partial liquidation.*—Thus far, we have shown that the artificial presumption created by Section 115 (b) is inapplicable here, and that the purchase of its own stock by the Foster Lumber Company is not to be allocated first against its most recent earnings account before it can be charged against the pre-March 1, 1913, earnings. There remains, however, the further question as to how that amount should be allocated, whether any *portion* of the recent earnings may be considered as having contributed toward the partial liquidation.

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the distribution to which the presumption was applied was an earlier non-capital distribution by the so-called New Company to Boxboard Products Company. Of course, the presumption was applicable there. And second, even if the presumption were applied to the partial liquidation, it would have been proper under the law then in force. The key transactions took place in 1923 while the Revenue Act of 1921 (c. 136, 42 Stat. 227) was in effect. Under that Act there was no provision comparable to Section 115 (c) of the 1928 Act, and distributions in liquidation were treated under that statute, not as capital transactions, but as dividends to the extent of available earnings accumulated since February 28, 1913. The Circuit Court of Appeals for the Second Circuit has specifically recognized this in *Commissioner* v. *Sansome*, 60 F. (2d) 931, 932.

The case of *Stewart* v. *Commissioner*, 29 B. T. A. 809, relied upon by petitioner, similarly has no relevance here. The Board plainly stated (p. 813) that a partial liquidation was not there involved.

Accordingly, we submit that neither the *Harter* nor *Stewart* case touches the question whether the presumption in Section 115 (b) should be applied to a capital transaction such as is involved herein.

We will discuss two possible methods of allocating the $1,025,000 expenditure against the various accounts of the corporation: first, the method used by the Court of Claims of not charging any portion against recent earnings; and second, the method of pro-rating the distribution evenly over all the accounts of the corporation, including the recent earnings. Both methods are sound and either of them would defeat petitioners' claim.

First. Since petitioners' decedent had no taxable gain upon the redemption in 1929, and since the redemption was purely a capital transaction, there is much cogency to the holding of the Court of Claims that the recent earnings were not invaded at all. That conclusion is reinforced by the general and dominant purpose of Congress to tax recent corporate earnings as far as possible to the stockholders. Accordingly, that purpose is given effect by keeping intact the reservoir of earnings from which taxable dividends could be declared whenever there is a non-taxable distribution.

That method is in accord with administrative practice of long standing. As early as I. T. 1802, II–2 Cumulative Bulletin 267, with respect to prior Revenue Acts, the Treasury had ruled that premiums paid in retiring capital stock should be charged first against the March 1, 1913, surplus. And the Treasury has consistently since then continued that practice.

Second. The second method, which we suggest is perhaps a more realistic approach to this problem.

It regards each share of stock as having behind it a proportional part of the various accounts of the corporation. Thus, each of the 2,000 outstanding shares on October 10, 1929, can be regarded as comprehending a proportionate share of the $200,000 paid-in capital, of the $330,578.98 earnings and profits accumulated since February 28, 1913, and of the undistributed earnings and profits accumulated prior to March 1, 1913.[7]

Accordingly, under this method, if the total net assets of the corporation be treated as $4,100,000,[8] the distribution of $1,025,000 would be charged against the earnings account of $330,578.98 to the extent of $\frac{1,025,000}{4,100,000}$, or in the amount of $82,664.75. Thus, the October, 1929, redemption would reduce the recent earnings account only to $247,934.25, which, even without the later earnings from October 10, 1929, to February 11, 1930, would be more than ample to pay the February 11, 1930, dividend of $225,000 here involved.

It will be noted that we have not discussed what part of the $1,025,000 "is properly chargeable to

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[7] On March 1, 1913, the surplus was $3,725,000. (R. 8.) And as shown in footnote 1, *supra*, that amount had been reduced by dividends thereafter in the aggregate amount of less than $100,000.

[8] This figure is arrived at by multiplying the 2,000 shares by $2,050, the amount which was treated as the value of each share. A somewhat greater figure would be reached by adding (1) $200,000 capital, (2) $330,578.98 recent earnings, and (3) the undistributed pre-March 1, 1913, earnings, which would be in excess of $3,625,000 if the 1913 amount is diminished by the 1914 and 1915 dividends to the extent that they invaded it.

capital account" within the meaning of Section 115 (c). For, if our contention that Section 115 (b) is inapplicable be accepted, then it is not material here how much should be charged to capital or whether "capital account" means merely paid-in capital, or March 1, 1913, surplus in addition to paid-in capital. The real issue is whether, even if the narrowest definition of "capital account" be adopted, the amount of the distribution in excess of that portion allocable to such capital account, should be attributed, first, to the recent earnings, and our position is that it should not. Accordingly, under our view that the excess is to be spread evenly over the various accounts of the corporation, the crucial question is how much, if any, must be allocated to the post-February 28, 1913, earnings. And we have shown (p. 17, *supra*) that such earnings account of $330,578.98 would be depleted at most in the amount of $82,664.75.

4. *But even if Section 115 (b) is applicable, then the 1929 redemption did not exhaust the recent earnings account, since the "capital account" of the corporation includes not only its paid-in capital but also the March 1, 1913, surplus.*—Assuming that we are incorrect as to the inapplicability of Section 115 (b), then the Government is still entitled to prevail. Under Section 115 (c) it is specifically provided that "the part of such distribution which is properly chargeable to capital account shall not be

considered a distribution of earnings or profits within the meaning of subsection (b) of this section * * *." And as we shall show, Congress employed the term "capital account" loosely to mean paid-in capital plus March 1, 1913, surplus.

Under this interpretation, the amount properly chargeable to capital would be $\frac{4,100,000 \text{ minus } 330,578.98}{4,100,000} \times$ $1,025,000, or $942,335.25. In short, there would remain only $82,664.75 to be taken out of post-February 28, 1913, earnings.

We submit that the clause "properly chargeable to capital account" refers broadly not merely to the technical paid-in capital, but also to the March 1, 1913, surplus. While Congress undoubtedly could tax dividends paid from pre-March 1, 1913, earnings (*Lynch* v. *Hornby,* 247 U. S. 339), it has elected not to do so, and has treated such earnings just as though they were capital for the purpose of determining taxability upon distribution. See *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, 335:

> * * * we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, *as being capital,* not income, for the purposes of the act. [Italics supplied.]

See also *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71, 72; *Lucas* v. *Alexander,* 279 U. S. 573, 577; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 556, Note 3. The question here is the intention to be

ascribed to Congress in using the term "capital," and we submit that it was used in the sense in which this Court has repeatedly used the same term.[9]

True, in *Helvering* v. *Canfield,* 291 U. S. 163, the Court said that the March 1, 1913, surplus was not "capital" in the sense that where it had been reduced by deficits, later earnings had to be applied to restore that fund before such later earnings could be distributed as taxable dividends. That decision, however, dealt not with the meaning of

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[9] A recent instance of the broad use of the term capital account to include March 1, 1913 surplus, is found in Treasury Regulations 94, dealing with the undistributed profits tax under the Revenue Act of 1936 (c. 690, 49 Stat. 1648). Article 27 (f)–1 (b) of those regulations states:

(*b*) *Amount properly chargeable to earnings or profits.*— In the case of a distribution in liquidation with respect to which a dividends paid credit is allowable (see paragraph (a) of this article) the amount of the credit is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. *The capital account, for purposes of these regulations, includes* not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and *such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock.* The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. [Italics in body supplied.]

the term "capital" as used in this or any other provision of the Revenue Acts, but with the concept of capital as a matter of corporate law. Furthermore, the very basis of that decision fortifies the result here. That decision proceeded in full recognition of the dominant purpose of Congress to tax as dividends corporate distributions to the extent that there were earnings after February 28, 1913, available, and that taxability was not to be defeated by any such artificial concept. We are confronted here by the same dominant purpose of Congress, and respectfully submit that the term "capital account" as loosely employed by it in Section 115 (c) should be construed to give effect to that purpose.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted,

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SEWALL KEY,
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DECEMBER, 1937.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the

case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(h) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Treasury Regulations 74:

ART. 622. *Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

ART. 623. *Distributions out of earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913.*—Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of Title I. A corporation can not distribute earnings or

profits accumulated or increase in value of property accrued prior to March 1, 1913, exempt from tax, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed. Whenever one corporation receives from another corporation distributions out of earnings or profits accumulated by such other corporation prior to March 1, 1913, or out of increase in value of its property accrued prior to March 1, 1913, and the "receiving" corporation, after having first distributed all of its earnings and profits accumulated since February 28, 1913, distributes to its shareholders the amount so received by it from such other corporation, the distribution by the "receiving" corporation to its shareholders is not a dividend within the meaning of Title I and is exempt from tax.

In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

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U. S. GOVERNMENT PRINTING OFFICE: 1937

SUPREME COURT OF THE UNITED STATES.

No. 189.—October Term, 1937.

Benjamin B. Foster and Robert R. Todd, Executors of the Estate of Anna Foster Ford, Deceased, Petitioners,
vs.
The United States.

On Petition for Writ of Certiorari to the Court of Claims.

[January 31, 1938.]

Mr. Justice Black delivered the opinion of the Court.

Petitioners' right (as executors) to an income tax refund depends upon whether a dividend paid by the Foster Lumber Company in 1930 is tax exempt as representing corporate earnings accumulated before March 1, 1913. This dividend is taxable under the Revenue Act of 1928[1] if paid from earnings accumulated after 1913. The Court of Claims found the dividend taxable.[2]

Petitioners contend that the 1930 dividend was traceable to the Company's pre-1913 accumulations because its post-1913 earnings had been exhausted by a distribution in 1929. The circumstances of the 1929 distribution and the 1930 dividend were:

The Foster Lumber Company was a family corporation, organized in 1896 with a capital stock of $200,000. March 1, 1913, when the federal income tax became effective, the increased value of the company's property and its undistributed profits were more than $3,725,000. Petitioners insist that a distribution of $1,025,000 on October 10, 1929, completely exhausted the $330,578.98 total undistributed profits which had accumulated since March 1, 1913. This 1929 distribution, however, was not a dividend. It was paid by the company to cancel and liquidate five hundred shares of its own $100 par value stock and represented payment of $2,050 per share, the agreed value as of March, 1913. February 11, 1930, the company declared a $225,000 dividend and this refund is sought for the tax paid upon a shareholder's part of this dividend. Be-

[1] c. 852, 45 Stat. 791.

[2] 17 Fed. Supp. 191; (supplemental opinion) 18 Fed. Supp. 790. Certiorari granted, 302 U. S. —.

tween October 10, 1929 (the date of the $1,025,000 stock purchase) and February 11, 1930 (the date of the $225,000 dividend) the company's earnings amounted to only $82,758.17. Petitioners take the position that only $82,758.17 of this $225,000 dividend of 1930 can be taxed, urging that the balance is tax exempt because it must be treated as representing pre-1913 accumulations.

Subsection (a) of Section 115 of the Revenue Act of 1928[3] defines "dividend", for income tax purposes, as "any distribution made by a corporation to its shareholders, . . . out of its earnings or profits *accumulated after February 28, 1913.*"

Subsection (b) of this income tax law exempts corporate earnings and profits accumulated before March 1, 1913. This subsection also provides that for income tax purposes all distributions are paid from "the most recently accumulated earnings or profits." The obvious purpose of the provision was to prevent corporations from attributing dividend payments to pre-1913 accumulations to avoid taxes imposed upon profits earned after March, 1913. Petitioners' contention is that the $330,578.98 earned after 1913, as "the most recently accumulated earnings or profits" was automatically exhausted in part payment of the $1,025,000 stock purchase and thus escaped taxation. In this manner, pre-1913 corporate non-taxable earnings could be used to avoid taxes on corporate profits earned after 1913.

We have previously said that Subsections (a) and (b), *supra*, construed together, disclose legislative purpose that pre-1913 accumulations shall not be distributed "in such a fashion as to permit profits accumulated after that date to escape taxation."[4] Petitioners ask that we now construe these provisions in a way which would facilitate the escape of such profits from taxation and thereby defeat the undoubted purpose of Congress. We are urged so to expand and broaden an exemption granted by Congress as a "concession to the equity of stockholders"[5] that such concession would in reality serve to nullify and defeat the tax on corporate profits earned after 1913. Courts should construe laws in harmony with the legislative intent and seek to carry out legislative purpose. With respect to the tax provisions under consideration, there is no uncertainty as to the legislative purpose to tax post-1913 corporate

[3] Revenue Act of 1928, c. 852, 45 Stat. 791, 822.
[4] Helvering *v.* Canfield, 291 U. S. 163, 168.
[5] Lynch *v.* Hornby, 247 U. S. 339, 346.

earnings. We must not give effect to any contrivance which would defeat a tax Congress plainly intended to impose. The use of bookkeeping terms and accounting forms and devices cannot be permitted to devitalize valid tax laws.

The transaction under which this Company paid $1,025,000 cash for its own stock of $50,000 par value does not fall within Subsections (a) and (b) of Section 115. Its character and effect are determined by Subsections (c) and (h) which relate to distributions in complete or partial corporate liquidation.[6]

Subsection (c), governing this stock purchase transaction, directs that "... In the case of amounts distributed in partial liquidation ... the part of such distribution which is *properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection* (b) ... *for the purpose of determining the taxability of subsequent distributions* ..."[7]

This provision of the Revenue Act of 1928 also substantially obtained in the Revenue Act of 1924.[8] Prior even to the 1924 Act, this Court had determined that, for income tax purposes, earnings of a corporation accumulated prior to 1913 are to be considered capital.[9] In the light of these decisions, Congress obviously intended that corporate funds distributed under the circumstances here shown should be "chargeable to capital account" and that stock purchases of the type here involved should not be considered "for the purpose of determining the taxability of subsequent distributions by the corporation."

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[6] Cf. Hellmich v. Hellman, 276 U. S. 233, 237.

[7] Subsection (h) (Revenue Act of 1928, *supra*, at 823): "Definition of partial liquidation.—As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

[8] Sec. 201 (c), c. 234, 43 Stat. 253, 255.

[9] "... we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as ... capital, ..." So. Pac. Co. v. Lowe, 247 U. S. 335 (1917). Also, see Lynch v. Turrish, 247 U. S. 221; Doyle v. Mitchell Bros. Co., 247 U. S. 179 (1917); "... what is called the stockholder's share in the accumulated profit of the company is capital, ..." Eisner v. Macomber, 252 U. S. 189, 219 (1919). Cf.: "... income ... (received) ... prior to the adoption of the Sixteenth Amendment ... had become capital prior to the adoption of the Amendment ..." Old Colony R. Co. v. Comm., 284 U. S. 557; and "... the accumulated profits, as they stood on March 1, 1913, constituted capital of the company ..." Helvering v. Canfield, 291 U. S. 167.

Acceptance of petitioners' contention would permit corporate profits accumulated since March, 1913 to escape taxation, contrary to the provisions and purpose of the 1928 Revenue Act. The bookkeeping mingling of corporate earnings and profits made before and after March 1, 1913, does not alter the Act nor can such action render taxable profits non-taxable. In this case, the distribution of $1,025,000 was "properly chargeable to capital account" and was not paid out of profits earned since March 1, 1913.

The $1,025,000, paid for the Company's stock, cannot, therefore, be considered "for the purpose of determining the taxability of subsequent distributions by the corporation" and this purchase of stock did not exhaust any part of the $330,578.98 profits accumulated since 1913. It follows that the total dividend of 1930 received by petitioners' decedent is taxable and the judgment of the Court of Claims is

Affirmed.

Mr. Justice CARDOZO took no part in the consideration or decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.